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January 4, 2008

To: Supervisor Yvonne B. Burke, Chair
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From: William T Fujioka
Chief Executive Officer

POTENTIAL IMPACT OF THE STATE'S STRUCTURAL DEFICIT ON THE COUNTY

In response to the Governor's announcement ordering all State departments to draft plans for potential spending cuts, on November 6, 2007, your Board requested the Chief Executive Officer (CEO) to prepare a report identifying how a 10 percent reduction to State programs could impact the County. In order to balance the Fiscal Year (FY) 2008–09 Budget, the State will have to adopt what is now reported to be $14.0 billion in solutions. In addition, as recently reported, the Governor announced his plan to issue a proclamation declaring a fiscal emergency and calling a special session of the Legislature to address a current-year budget shortfall of $3.3 billion.

We surveyed all departments for their perspective on how State cutbacks might affect County programs. Responses were of necessity based upon hypothetical estimates, since no reduction specifics have been provided by the State. They represent only potential scenarios, which should not be considered firm at this time. We must await specifics in the Governor's budget proposal, due out January 10, 2008.

Previous Structural Budget Deficit

Upon his election in October 2003, Governor Schwarzenegger called the Legislature into a special session to deal with the structural State budget deficit. At that time, the Governor also instructed State departments to prepare plans for 10 percent across-the-board reductions. Ultimately, these reductions did not occur because the Governor and the Legislature enacted short-term fixes to address budget deficits and pass a balanced budget. These fixes included: borrowing, deferring Proposition 98 payments, shifting Proposition 42 transportation funds to the State General Fund, suspending cost of living adjustments in social service programs, increasing fees, and developing revenue sharing agreements involving Indian gaming.

In addition, a series of voter-approved initiatives allowed the State to issue deficit reduction bonds to meet State obligations, required the Legislature to enact a balanced budget and established a State General Fund budget reserve known as the Budget Stabilization Account (BSA).

From the County's perspective, the most notable of the initiatives approved by the voters was Proposition 1A, the Protection of Local Government Revenues Act, which passed in November 2004. Proposition 1A was negotiated by the Governor and local governments in response to the Governor's FY 2004-05 Budget proposal to permanently shift $1.3 billion in local property taxes from counties, cities, special districts and redevelopment agencies to schools. Under Proposition 1A, local governments agreed to contribute $1.3 billion to the State for two years in return for constitutional protection of local revenue and services. However, effective FY 2008-09, Proposition 1A allows the State to borrow up to eight percent of the total amount of property tax revenues allocated among all local agencies within a county upon the Governor's declaration of a severe fiscal hardship. Borrowing can only take place twice in a ten-year period and only if the State has fully repaid any prior loans.

Potential State Budget Solutions Impacting the County

As part of this review, we contacted the California State Association of Counties (CSAC). Although the specific State cuts are not yet known, CSAC commented that the State's initial focus of reductions will likely be in internal administrative areas (i.e., eliminating vacant positions, and streamlining operations.) Therefore, the exact impact to Los Angeles County and other local government agencies is not known at this time.

However, we asked departments to provide potential impacts based on past experience, such as what was contemplated in 2003.

Based on the past State budget reduction proposals affecting counties and the provisions of Proposition 1A, it is possible the County will confront the following proposals as part of the Governor's plan to address the projected $14.0 billion budget shortfall.

Enact Provisions of Proposition 1A of 2004 - As allowed under Proposition 1A of 2004, the Governor could declare "a severe State fiscal hardship" and borrow county and special district property taxes to offset the budget shortfall. This would require passage of an urgency bill suspending protection for counties against a State takeover of property taxes and enactment of a separate bill providing for repayment of the "loan" plus interest within three years. The impact to the County General Fund, if property tax revenue is borrowed by the State in FY 2008-09, is estimated to be $208.0 million.

(This amount was calculated based on the County's total estimated property taxes for FY 2007-08, excluding property tax in-lieu of vehicle license fees and property tax in-lieu of sales tax.)

SB 90 Deferred Mandate Payments - The Governor could further extend or suspend the repayment of deferred mandate payments to counties for unpaid approved claims relating to FYs 2001-02, 2002-03 and 2003-04. The State is obligated to repay these claims over a 15-year period. The outstanding balance of deferred mandate claims for these three fiscal years totals approximately $133.0 million. Suspension or deferral of the statutorily required annual payment would reduce County revenue in FY 2008-09 by $10.0 million.

Transportation - Since 2002, the State has suspended the transfer of Proposition 42 gasoline sales tax revenues twice due to the State's fiscal situation. However, the State's ability to suspend Proposition 42 transfers is now limited by the voter-approved Proposition 1A of 2006, the Transportation Funding Protection Act. Proposition 1A of 2006 makes it more difficult for the State to suspend the transfer of Proposition 42 funds by requiring the Governor to declare that the suspension is necessary due to "a severe State fiscal hardship." The suspension would require approval by a two-thirds vote of the State Legislature with enactment of a measure to repay the funds, with interest, within three years. Proposition 1A of 2006 also limits Proposition 42 suspensions to two fiscal years over a ten-year period and prohibits any future suspensions unless prior suspensions are fully repaid. The estimated impact in FY 2008-09 if the State suspends Proposition 42 funds is $61.0 million.

However, the transfer of Proposition 42 funds may be prohibited completely if voters approve Proposition 91, Transportation Funding, which will be on the February 5, 2008 ballot. Proposition 91 would amend the State Constitution to eliminate the State's authority to suspend transfer of gasoline sales tax revenues and limit the State's ability to borrow these funds for non-transportation uses.

Given the Proposition 1A of 2006 restrictions and pending the outcome of the 2008 February election, the Governor's ability to suspend Proposition 42 funds to offset the budget deficit is limited at this time. The Governor could propose to defer repayment of the Proposition 42 suspensions which occurred in FY 2003-04 and FY 2004-05. If Proposition 91 is defeated, the Governor could declare a fiscal emergency to allow the suspension of Proposition 42 funds in FY 2008-09.

Social Services Programs - The Governor could propose reductions in various social services programs which may result in a cost shift to the County. Other reductions could impact the County's clients, but not directly impact net County cost. The

Departments of Public Social Services and Children and Family Services (DCFS) estimated a combined loss of revenue of $300.0 million for programs they considered at risk of reduction in FY 2008-09. Revenue reductions of this magnitude would require significant policy decisions on backfilling these revenues. Impacts could include:

- A ten percent reduction to Public Assistance Programs such as CalWORKS, IHSS, CAPI (Cash Assistance Program for Immigrants) and General Relief (GR), Welfare-to-Work, Cal-Learn and Child Care would result in revenue reductions of $193.0 million. These reductions would reduce cash grants for CalWORKS, CAPI and GR participants; eliminate the Safety Net grant for children; impose sanctions for CalWORKS families not complying with welfare-to-work requirements; limit child care for working families after leaving CalWORKS; and eliminate enrollment in welfare programs for documented immigrants. For IHSS, it would freeze provider wages and benefits at the current level or reduce State participation to the State minimum rate ($8.00 per hour effective January 1, 2008).

- A ten percent reduction to other welfare programs such as Medi-Cal, Food Stamps and General Relief would result in $70.0 million in revenue reductions. These reductions would reduce services to immigrants through the California Food Assistance and Healthy Families for Documented Immigrants programs.

- A ten percent reduction in administrative support for all public welfare programs would cause $19.0 million in revenue reductions. These reductions could affect the approval rate of IHSS applicants, cause delinquent annual re-assessments resulting in penalties and severely impact all administrative support functions.

- Elimination of funding for the transitional housing program for emancipated foster youth ($2.0 million) and support for administration of the Medi-Cal program ($16.0 million) as it affects children under supervision of DCFS and, the Probation Department - $18.0 million in revenue reductions, if funding were completely eliminated.

Mandated Mental Health Programs - As part of the 2007 State Budget Act, the State opted to delay reimbursement of an estimated $300.0 million to counties for the Early and Periodic Screening, Diagnosis, and Treatment (EPSDT) Program and $77.0 million for Los Angeles. The State approved a plan to reimburse counties over a three-year period. The Governor could further extend the EPSDT repayment schedule, which would result in a $26.0 million revenue reduction and potentially use this option to delay reimbursement for other mandated programs such as the AB 3632 Mental Health Services for Special Education Students Program.

In addition, the Department of Mental Health estimated a revenue loss of $7.6 million for the managed care program if a ten percent reduction is enacted in FY 2008-09.

Proposition 36 - The Governor could propose to reduce or eliminate funding for the Substance Abuse and Crime Prevention Act (Proposition 36) program. If a ten percent reduction is enacted, the County would lose $3.0 million; however, the Governor could eliminate all funding for which the County's share of Proposition 36 funding is $30.0 million.

Justice Programs - The Governor could reduce or eliminate all funding for a number of critical programs. A ten percent reduction would have a financial impact of $12.9 million as follows: Juvenile Justice Crime Prevention Act ($3.3 million), Citizens' Option for Public Safety ($0.9 million), Mentally Ill Offender Crime Reduction ($0.3 million), Standards and Training for Corrections ($0.4 million), and juvenile probation camps ($8.0 million).

Library Funding - As part of the 2007 State Budget Act, the Governor vetoed a proposed $1.0 million augmentation to the Public Library Foundation Program and instead reduced program funding by $7.0 million. The Governor also eliminated an additional $7.0 million for the Direct Loan and Interlibrary Loan Program. The Governor could freeze current funding for these programs at the current level or eliminate it for a loss of $1.5 million.

Shift Federal Penalties to Counties - The Governor could propose that counties be held responsible for paying Federal penalties for child welfare overpayments, for which we cannot provide an accurate estimate; and penalties due to delays in implementing the statewide Child Support automation system. In prior years, the County has estimated $11.0 million in annual penalty for Child Support automation.

February 2008 Presidential Primary Election - The Governor has indicated that he plans to include funding to reimburse county costs for the 2008 Presidential Primary in the FY 2008-09 Budget as required by SB 113 (Chapter 2, Statutes of 2007). The Governor could suspend or defer the reimbursement to the County estimated at approximately $20.0 million.

<u>**Other Potential Departmental Impacts**</u>

On November 27, 2007, we asked departments to determine the programs most likely to be at risk of reduction based on past experience. Below are additional impacts to programs that departments considered possibly at risk in FY 2008-09 that were not contemplated by the State in the 2003 plan:

- Public Health Programs - Children's Medical Services and Office of Aids Programs and Policies) - $5.1 million; and

- Various other revenue impacts for Agricultural Commissioner/Weights and Measures, District Attorney, Parks and Recreation, and Public Defender - $1.6 million.

Based upon information provided by departments at this time, total impact of the above scenarios could be as great as $694.7 million. This does not mean that the State will reduce funding Los Angeles County by that amount, but rather represents options the State has considered in the past.

Many of the potential State budget reductions would result in reduced State revenues to the County, thereby affecting various programs administered by the County. These reductions in State revenues would cause reductions in services and/or benefits to program recipients requiring significant Board policy discussion regarding using limited discretionary County resources to backfill. Several departments have indicated they are not able to provide impacts until specific reductions are known.

The Governor's Budget is scheduled for release on January 10, 2008, at which time we ~~can better assess impacts on the County. We are currently~~ developing strategies, for implementation shortly after the Governor's Budget is analyzed, including budget reductions through targeted reduction scenarios and targeted controls on hiring.

In addition, we are already taking proactive actions to prepare for the anticipated State reductions by requesting departments to limit non-critical hiring and expenditures; limiting action budget adjustments, which allow departments to transfer up to $250,000 in appropriation within their existing departmental appropriation, and closely monitoring departmental expenditures and revenues, as well as Countywide revenues.

Please contact Ed Corser at (213) 974-2291 if you have any questions or need additional information.

WTF:DL:SK
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c: Executive Officer, Board of Supervisors

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